

DEPARTMENT OF STATE REVENUE

04960121.LOF

LETTER OF FINDINGS NUMBER: 96-0121 RST

Sales and Use Tax

For The Periods: 1993 Through 1994

**NOTICE:** Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

**I. Sales and Use Tax - CAD/CAM Equipment**

Authority: IC 6-2.5-3-2; 6-2.5-5-3; 45 IAC 2.2-5-8

The taxpayer asserts that its CAD/CAM equipment is fully exempt from sales and use tax.

**II. Sales and Use Tax - Items for Resale**

Authority: IC 6-2.5-5-8

The taxpayer protests the lack of credit given for sales tax paid on items purchased for resale.

**III. Sales and Use Tax - Printing Materials**

Authority: IC 6-2.5-5-36

The taxpayer protests the lack of credit given for Indiana gross retail tax paid on transactions involving commercial printing.

**IV. Sales and Use Tax - Promotional Materials**

Authority: IC 6-2.5-5-1; IC 6-2.5-5-2; Miles, Inc. v. Indiana Department of State Revenue, 659 N.E.2d 1158 (Ind.Tax 1995); U.S. Air, Inc. v. Indiana Department of State Revenue, 623 N.E.2d 466 (1993)

The taxpayer protests the assessment of and lack of credit given for Indiana use tax paid on all promotional items temporarily stored in Indiana for subsequent use outside of Indiana.

**V. Tax Administration - Imposition of Negligence Penalty**

Authority: I.C. 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the imposition of the ten percent (10%) negligence penalty.

STATEMENT OF FACTS

The taxpayer is manufacturer of upholstered furniture. The Department audited the taxpayer for the tax period of 1993 and 1994. Prior to the hearing several audit issues under protest were resolved. The Department's memorandum of changes to audit report is incorporated into the file. The taxpayer protests the following issues that were not resolved.

**I. Sales and Use Tax - CAD/CAM Equipment**

DISCUSSION

The taxpayer protests the imposition of use tax on purchases of CAD/CAM equipment. The taxpayer states that it uses the equipment within the production process. The taxpayer was denied an exemption upon sixty percent (60 %) of the equipment. The auditor determined that all steps leading up to the actual printing of the final design (stencil) were of a taxable nature.

The taxpayer argues that both the computer tapes and the product description sheets direct production. The taxpayer claims that without the production description sheets, the employees would be unable to perform their production-related functions. (Taxpayer's letter p. 5)

In support of its argument, the taxpayer cites Indiana Code 6-2.5-5-3 (b):

Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring the property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

The taxpayer states that the product description sheet produced by the CAD/CAM is a detailed explanation of procedures and production specifications that leads employees through the production process. (Taxpayer's letter p. 4) The taxpayer cites 45 IAC 2.2-5-8 (g)(6):

Computers which are interconnected with and control other production machinery or are used to make tapes which control computerized production machinery are exempt from tax.

However, the Department's regulations at 45 IAC 2.2-5-8 (g)(7) state:

Computers which produce designs which are not sold as products are not exempt. Thus, computer-aided design is a non-exempt function.

The auditor agreed with the taxpayer that the last step of the CAD/CAM process (final design) was found

to be exempt under 45 IAC 2.2-5-8 (g)(6). The taxpayer is creating designs with their system; however, the designs are not sold as product and do not qualify for the exemption.

The auditor applied 45 IAC 2.2-5-8 (g)(8) which reads:

A computer is used 40% of the time for the purpose described in Example (6) and 60% of the time for the purpose described in Example (7). The taxpayer is entitled to an exemption equal to the 40% of the gross retail income attributable to the transaction in which the computer was purchased.

The taxpayer's CAD/CAM system was used in the manner of both example (6) and (7) in 45 IAC 2.2-5-8 (g). The auditor was correct to grant only partial exemption for the use of the CAD/CAM system in production.

Alternatively, the taxpayer also argues IC 6-2.5-5-4 which states:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for his direct use in the direct production of the machinery, tools, and equipment described in...IC 6-2.5-5-3.

The Department does not agree with this interpretation of the regulations. The assessment in the audit report was correct. The Department's policy regarding the CAD/CAM systems is that they partially perform pre-production activities. In this analysis, the Department focuses on the end products and the tangible personal property used to produce the products. In this situation, the custom products are the exempt stencils and not the coded instructions created by the CAD system.

#### **FINDING**

The taxpayer's protest is respectfully denied.

### **II. Sales and Use Tax – Sale for Resale**

#### **DISCUSSION**

The taxpayer purchased furniture that it disassembled, studied, and/or copied for Research and Development purposes. The auditor would not credit the purchases. The taxpayer contends that the furniture was still resold at cost or below cost and sales tax was remitted thus the sales for resale exemption found in IC 6-2.5-5-8 would apply.

IC 6-2.5-5-8 states:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of his business without changing the form of the property.

In order for the taxpayer to qualify for the exemption, the statute requires the taxpayer to acquire property for the purpose of resale. However, the taxpayer purchased the furniture for the purpose of studying and copying for duplication rather than resale. Once the needs of the taxpayer were satisfied the furniture was sold at marginal gain or at cost. The fact that the taxpayer is able to sell the furniture in order to recoup its cost does not allow the taxpayer to qualify for the exemption.

#### **FINDING**

The taxpayer's protest is denied. The furniture was purchased for the primary purpose of research and product development rather than for the purpose of resale.

### **III. Sales and Use Tax – Printing Materials**

#### **DISCUSSION**

The taxpayer purchases film prints, proof prints, transparencies, photostats and negatives and gives them to a commercial printer. The printer uses these items to print promotional materials for the taxpayer (i.e. catalogs and brochures). If the printer had purchased these materials instead of having them provided by the Smith Brothers, these purchases would be exempt from sales and use tax. The taxpayer was assessed use tax in the audit assessment. This is contrary to IC 6-2.5-5-36:

Transactions involving tangible personal property acquired by a person that has contracted with a commercial printer for printing are exempt from the state gross retail tax, if the property is acquired for use at the commercial printer's premises and the commercial printer could have acquired the property exempt from state gross retail tax and use tax.

The taxpayer is entitled to the exemption for the taxable years beginning after December 31, 1992.

#### **FINDING**

The taxpayer's protest is sustained.

### **IV. Sales and Use Tax – Promotional Materials**

#### **DISCUSSION**

The taxpayer distributes fabric samples and other promotional items for use out of state. The taxpayer argues that it did not exercise taxable use over these materials. The taxpayer only stored the items before shipping them for use outside of Indiana.

The taxpayer's situation may be viewed in the context of Miles, Inc. v. Indiana Department of State Revenue, 659 N.E.2d 1158 (Ind.Tax 1995). In this case, the court ruled that the activities of storing, incidental handling, and transporting the property could not be taxed as "uses". "Use" was not defined by the Tax Court in Miles; however, the Tax Court in U.S. Air, Inc. v. Indiana Department of State Revenue, 623 N.E.2d 466 (1993) held that the storage exception limits and qualifies the meaning of "use". The Department recognizes the fact that the Tax Court has included the wording "incidental handling" within the "storage" exception and the activities of unpacking, sorting, repackaging, labeling the package, and transporting the product out of state are "incidental activities" in connection with the "storage" exception. However, any activity that exceeds incidental handling for storage purposes is considered "use" that would not be exempt under the storage exception.

The taxpayer's activities of temporary storage fall under the definition of "incidental handling" for storage purposes. As a consequence of the Miles decision, the temporary storage of promotional materials would qualify for the storage exemption from use tax under IC 6-2.5-3-1(b) to the extent that the property is used solely outside Indiana.

Also, the taxpayer states that it purchased some of its materials from in-state as opposed to out-of-state vendors. The taxpayer asserts that in Miles, the items were found not to be subject to sales or use tax regardless of whether the purchases came from in-state vendors or out-of-state vendors. Sales tax was not an issue in Miles because in that case, Miles did not pay sales tax to the vendors in Indiana.

However, all purchases of promotional materials from Indiana vendors are subject to sales tax and are not refundable because the storage exception only applies to use tax. The purchases of promotional materials from out-of-state vendors are not subject to Indiana sales tax because the sale is completed outside of Indiana. The property is subject to Indiana use tax if it is used in Indiana unless it comes under the storage exception.

#### **FINDING**

The taxpayer's protest is partially sustained and partially denied. The taxpayer does qualify for the use tax storage exception for stored promotional materials subsequently shipped out of Indiana with no more than incidental handling taking place in this state; however, if the taxpayer purchased the materials from an in-state vendor and paid sales tax, the transaction does not qualify for a refund because there is no storage exception for sales tax in the statute, and the transaction is subject to Indiana sales tax as a sale completed in Indiana.

#### **V. Tax Administration -- Imposition of Negligence Penalty**

##### **DISCUSSION**

Indiana Code 6-8.1-10-2.1 (d) states, in part, that if, "the deficiency determined by the Department was due to reasonable cause and not willful neglect, the Department shall waive the penalty."

Regulation 45 IAC 15-11-2 (b) also states, in part:

(b) "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer.

The taxpayer has shown that it used reasonable care in its self-assessment of use tax.

#### **FINDING**

The taxpayer's protest is sustained in regard to the penalty issue.